DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 01-0121
Financial Institutions Tax
For the Tax Years 1994, 1995, and 1996

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ISSUES

I. Date Upon Which Taxpayer Entered Into a Unitary Relationship with Its Out-of State Banking Group.

Authority: IC 6-5.5-1-18(a); IC 6-5.5-1-18(b); 45 IAC 17-3-5(c).

Taxpayer argues that the date upon which the audit determined that taxpayer entered into a unitary relationship with its out-of-state banking group – May 2, 1996 – was incorrect. Taxpayer maintains that the particular facts surrounding the acquisition of the out-of-state banking group establish that the unitary relationship was not established until approximately January 1, 1997.

II. Calculation of Taxpayer's Foreign Source Income – Exclusion of Related Expenses in Determining Taxpayer's Adjusted Gross Income.

Authority: IC 6-5.5-1-2(a); IC 6-5.5-1-2(a)(2)(B); IC 6-8.1-5-1(b).

Taxpayer argues that expenses related to the acquisition of its foreign source income should not be deducted from that foreign source income. In the alternative, taxpayer asserts that the audit calculated the foreign source income expenses based upon incomplete information and that the correct calculation of those expenses would reduce the amount of expenses.

III. Enterprise Zone Loan Interest Credit – Credit on Interest Taxpayer Derived from Loans to Churches and Not-for-Profit Organizations.

Authority: IC 6-3.1-7-1 to -6; IC 6-3.1-7-1; IC 6-3.1-7-2.

Taxpayer argues that it is entitled to a credit for enterprise zone loan interest derived from loans made to churches and not-for-profit organizations located within "enterprise zones."

IV. Abatement of the Ten-Percent Negligence Penalty.

Authority: IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b) 45 IAC 15-11-2(c).

Taxpayer argues that audit's imposition of the ten-percent negligence penalty against the additional assessment for calendar year 1996, was in error because any tax deficiency was not due to negligence. Alternatively, taxpayer argues that the negligence penalty should be apportioned – i.e. taxpayer was "negligent" on issue number one and not "negligent" for issue number two.

STATEMENT OF FACTS

Taxpayer is a diversified financial institution incorporated and domiciled in Indiana. Taxpayer provides financial services including commercial and retail banking, trust, investment, item processing, mortgage banking, and credit card processing. Taxpayer is subject to the state's Financial Institutions Tax (FIT). The Department conducted an audit of taxpayer's records for the calendar years 1994, 1995, and 1996. The audit determined that taxpayer owed additional taxes and assessed the ten-percent negligence penalty against the taxes attributable to the calendar year 1996. The taxpayer protested certain portions of the assessment, an administrative hearing was held, and this Letter of Findings results.

DISCUSSION

I. Date Upon Which Taxpayer Entered Into a Unitary Relationship with Its Out-of State Banking Group.

For the tax years at issue, taxpayer determined that it was part of a unitary group. On May 2, 1996, taxpayer completed the purchase of an out-of-state banking group. The audit determined that the out-of-state banking group was assimilated into taxpayer's business such that the out-of-state banking group should have been included with taxpayer's unitary filing for calendar year 1996. The taxpayer included the out-of-state banking group within its federal 1996 consolidated return.

The audit came to this conclusion based, in part, on a statement included within taxpayer's 1996 Annual Report. The Annual Report statement on which the audit relied reads as follow:

> The reported numbers include the results of [out-of-state banking group] . . . . which merged with [taxpayer] in a pooling-of-interests transaction consummated in May. As of June 1996, less than 30 days after closing, the new [out-of-state banking group] made its debut, with all systems and procedures of the former [of-of-state banking group] converted to [taxpayer's] single operating system. While the cost saving achieved from merger integration enhance the initial return from this transaction, the real payoff is the opportunity for revenue growth – marketing [taxpayer] products and services in [out-of-state banking group's location]. It is clear that our earnings, and our growth rate, will benefit from this acquisition for years to come.

Taxpayer maintains that the audit's determination was erroneous. According to taxpayer, the assimilation of out-of-state banking group should not be based upon the date upon which the acquisition was consummated. Rather, taxpayers' assimilation of the out-of-state banking group – for purposes of determining the taxpayer's adjusted gross income – was an on-going process. Certain steps toward assimilation of the out-of-state banking group – presumably to assure

continuity of services to out-of-state banking group's customers – took place before May 2. Other steps in this on-going assimilation process took place subsequent to the May 2 date.

Essentially, argues that a unitary relationship was not established with the out-of-state banking group until January 1, 1997.

The statutory definition of a "unitary business" is found at IC 6-5.5-1-18(a), (b).

> "Unitary business" means business activities or operations that are of mutual benefit, dependent upon, or contributory to one another, individually or as a group, in transacting the business of a financial institution. The term may be applied within a single legal entity or between multiple entities and without regard to whether each entity is a corporation, a partnership, a limited liability company, or a trust, provided that each member is either a holding company, a regulated financial corporation, or a subsidiary of either, a corporation that conducts the business of a financial institution under IC 6-5.5-1-17(d)(2), or any other entity, regardless of its form, that conducts activities that would constitute the business of a financial institution under IC 6-5.5-1-17(d)(2) if the activities were conducted by a corporation. The term "unitary group" includes those entities that are engaged in a unitary business transacted wholly or partially within Indiana.
>
> Unity is presumed whenever there is unity of ownership, operation, and use evidenced by centralized management or executive force, centralized purchasing, advertising, accounting, or other controlled interaction among entities that are members of the unitary group, as described in subsection (a). However, the absence of these centralized activities does not necessarily evidence a nonunitary business. *See also* 45 IAC 17-3-5(c).

The taxpayer asks the Department to adopt an elastic standard for marking the onset of a unitary relationship in which "ownership" is simply one factor in determining the existence of that relationship. However, there are few compelling reasons for adopting such an amorphous standard. IC 6-5.5-1-18(b) states that a unitary relationship is presumed "whenever there is unity of ownership, operation, and use . . . ." Obviously, the precise exigencies surrounding the acquisition of a fully function banking operation will vary widely depending on the acquiring entity's specific intentions. In some circumstances, the acquiring entity will act to entirely subsume the acquired banking operation; thereafter, the acquired banking operation will lose all vestiges of individual identity and operation. In other circumstances, the acquiring entity will permit the acquired banking operation to retain its individual identity and freedom of operation; even after the formal acquisition has been full consummated, the acquiring entity will exercise only the most tenuous control over the acquired banking operation. Under either set of circumstances, the one objectively certain factor is "ownership." The remaining two factors – "use" and "operation" are less quantifiably precise but, nonetheless, inexorably follow the acquisition of the target banking operation.

Under any reasonable interpretative application of IC 6-5.5-1-18(a), (b), taxpayer entered into a unitary relationship with the out-of-state banking group on the date taxpayer acquired ownership of the group.

FINDING

Taxpayer's protest is respectfully denied.

II. Calculation of Taxpayer's Foreign Source Income – Exclusion of Related Expenses in Determining Taxpayer's Adjusted Gross Income.

Taxpayer protests the audit's decision to reduce the taxpayer's amount of taxpayer's foreign source income exclusion.

In calculating the amount of foreign source dividends taxpayer was entitled to deduct from its federal adjusted gross income, the audit reduced the amount of foreign source by the amount of expenses taxpayer stated on its Federal Form 1118.

In calculating taxpayer's state FIT liability, the starting point is the taxpayer's federal adjusted gross income. IC 6-5.5-1-2(a) states that, "Except as provided in subsections (b) through (d), 'adjusted gross income' means income as defined in Section 63 of the Internal Revenue Code . . . ."

However, the taxpayer is entitled to exclude certain income from the amount of its federal adjusted gross income. Specifically, IC 6-5.5-1-2(a)(2)(B) permits the taxpayer to subtract "Income that is derived from sources outside the United States, as defined by the Internal Revenue Code."

Therefore, the taxpayer does not have to pay the FIT on "foreign source income." However, the amount of "foreign source income" the taxpayer may subtract from its federal adjusted gross income is not unrestrained. The Department requires the taxpayer to add back to its "foreign source income" those expenses related to obtaining that "foreign source income." The Department's rationale for doing so is plain; if Indiana starts with federal taxable income – an amount arrived at by deducting all relevant business expenses – but allows a straightforward deduction of the taxpayer's foreign source income, then the taxpayer, in effect, is receiving a double deduction of the expenses related to that foreign source income.

Taxpayer challenges the audit's deduction of the expenses on two grounds: First, taxpayer argues that there is no statutory or regulatory basis on which to permit an expense adjustment in tandem with the exclusion for foreign income and that the audit's proposed adjustment goes beyond the scope of the statute; Second, taxpayer maintains that even if some expense disallowance were appropriate, the method used by the audit to determine the amount of expenses overstates the actual amount of expenses.

The taxpayer's facial challenge to the Department's practice of deducting from its "foreign source income" those expenses related to the acquisition of that income, does not survive close scrutiny. In calculating – for purposes of the FIT – taxpayer's adjusted gross income, the taxpayer has provided no justification for allowing it to effectively "deduct" its expenses two times over. Such a proposed methodology finds no basis either in law or common sense.

The audit referenced taxpayer's Federal Form 1118 to determine the amount of expenses related to the acquisition of its foreign source income. However, according to taxpayer, "Use of the Form 1118 as the basis for the adjustments results in the disallowance of expenses which insufficiently related to the [foreign source income] to justify the adjustment." Taxpayer argues that Federal Form 1118 is a blunt instrument which substantially overstates the actual amount of foreign source income expenses. Taxpayer maintains that the federal system of calculating foreign source income expenses, arbitrarily allocates a raw percentage of its *total* expenses as expenses related to the foreign source income whether or not that allocation to foreign source income is based in financial reality. For example, taxpayer offers the hypothetical example of a Singapore treasury bond purchase. Taxpayer's actual expenses related to this essentially passive investment are insubstantial yet – according to taxpayer – the Federal Form 1118 arbitrarily attributes a certain percentage of its total expenses toward the maintenance of this investment.

Taxpayer's secondary argument must also be rejected. Even if taxpayer is entirely correct in asserting that the Federal Form 1118 is an inexact instrument for calculating its foreign income expenses, the alternative information it has provided is insufficient to overcome the presumption of correctness which attaches to the audit's original calculation. As set out in IC 6-8.1-5-1(b), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid." There is no basis for substituting the equally imprecise supplementary information for the audit's original calculation based upon the taxpayer's own Federal Form 1118. "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." Id.

FINDING

Taxpayer's protest is respectfully denied.

III. Enterprise Zone Loan Interest Credit – Credit on Interest Taxpayer Derived from Loans to Churches and Not-for-Profit Organizations.

The audit determined that taxpayer was not entitled to a credit for interest received on certain loans made within an "Enterprise Zone." Specifically, the audit disallowed the credit for loans made to churches and not-for-profit organizations. The audit reasoned that the churches and not-for-profit organizations lacked a qualifying business purpose.

The statutory scheme, IC 6-3.1-7-1 to -6, permits taxpayer to claim a credit against its state FIT liability if it receives interest on a "qualifying loan" made to an organization located within an enterprise zone.

IC 6-3.1-7-1 states in part as follows:

> "Qualified loan" means a loan made to an entity that uses the loan proceeds for: (1) a purpose that is directly related to a business located in an enterprise zone; (2) an improvement that increases the assessed value of real property located in an enterprise zone; or (3) rehabilitation, repair, or improvement of a residence.

The credit which taxpayer seeks to obtain is defined in IC 6-3.1-7-2 which reads:

> (a) A taxpayer is entitled to a credit against his state tax liability for a taxable year if he receives interest on a qualified loan in that taxable year.
>
> (b) The amount of the credit to which a taxpayer is entitled under this section is five percent (5%) multiplied by the amount of interest received by the taxpayer during the taxable year from qualified loans.

The audit was correct in concluding that a church or not-for-profit organization is not a "business" in the conventional sense of that word. After all, a church or not-for-profit organization does not manufacture widgets, sell groceries, provide dry-cleaning services, or perform any of the activities that one would readily associate with having a "business purpose." However, the language found within IC 6-3.1-7-1 does not impose such a restraint on a "qualifying loan." The statute plainly allows the taxpayer to claim the interest credit for loans made to an enterprise zone "entity" which uses the loan proceeds for "an improvement that increases the value of real property in an enterprise zone." IC 6-3.1-7-1.

FINDING

Taxpayer's protest is sustained.

IV. Abatement of the Ten-Percent Negligence Penalty.

Of the three years considered by the audit, the ten-percent negligence penalty was assessed against the additional assessment for 1996. The additional assessment is attributed largely to taxpayer's failure to include the out-of-state banking group within its unitary return. Taxpayer asks the Department to exercise its discretion to abate the ten-percent negligence penalty. Taxpayer argues that its positions concerning the state's Financial Institutions Tax were based upon good faith interpretations of the relevant statutes, Indiana case law, and Department policy; were not due to negligence or intentional disregard of the law; and that the original determination of its tax liability had a reasonable basis.

In the alternative, taxpayer argues that assessment of the ten-percent negligence paints with too broad a brush. Taxpayer argues that the Department should wend its way through the additional assessments, determine which of those additional assessments can be attributed to a particular "negligent" act, and then assess the penalty against only those portions of the additional assessments directly attributable to the particular negligent act.

IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

Taxpayer was assessed the ten-percent negligence penalty primarily based on its failure to include the newly acquired out-of-state banking entity in its 1996 Indiana FIT return while simultaneously including the entity in its federal consolidated return for that same year. Taxpayer has provided sufficient indicia to establish the failure to include the entity in FIT was due to "reasonable cause."

FINDING

Taxpayer's protest is sustained.

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